IPAMS
Independent Petroleum Association of Mountain States

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Mr. David S. Guzy, Chief
Rules and Procedures Staff
Mineral Management Service
Royalty Management Program
P.O. Box 25165, MS 3101
Denver, Colorado 80225-0165

Via Facsimile and First Class Mail

Re: Independent Petroleum Association of America
Independent Petroleum Association of Mountain States
Comments-Proposed Rulemaking-Amendments to Gas Valuation Regulations for Federal Leases, 61 Fed. Reg. 25421-25425

Dear Mr. Guzy:

The Independent Petroleum Association of Mountain States (IPAMS) is a non-profit, non-partisan trade association representing the interests of independent oil and natural gas producers, royalty owners, industry consultants and service/supply companies operating in the Rocky Mountain region.

The Independent Petroleum Association of America (IPAA) is a national trade association of approximately 5500 members that represents the interests of independent domestic natural gas and crude oil producers. IPAA's members are engaged in the exploration for, and production and sale of, natural gas, and are keenly interested in the methodology pursuant to which royalties will be calculated and paid.

The Minerals Management Service (MMS) reopened the public comment period for the proposed gas valuation regulations, requesting additional comments on five options for further rulemaking published in the Federal Register, May 21, 1996. IPAMS and IPAA (referred to jointly as the Trade Associations) submit the following comments to that request.

Many Trade Association members agree with Director Cynthia Quarterman's remarks made at a recent Congressional hearing that the current gas valuation system is not working. The index pricing methodology proposed by the MMS, however, would only increase the burden to independent producers. In their initial comments dated February 1, 1996, the Trade Associations stated that they could not support the proposed rule, in general, because the complexity of the proposed methodology "coupled with the requirement that producers pay on entitlements, whether the producer takes or not, will discriminate against independents and leave them at a competitive disadvantage." At the same time the Trade Associations supported the proposals to eliminate allowance forms, eliminate dual accounting for non-arm's-length sales of processed gas, to permit valuation of natural gas liquids on a wellhead MMBtu basis and to clarify the term "gathering", permitting the deduction of downstream compression expense.

With the reconvening of the Gas Valuation Negotiated Rulemaking Committee ("the Committee") and the reopening of public comments, the Trade Associations carefully reviewed the MMS options and met with their members and members of other associations to determine if industry could agree on an index-based alternative. A critical aspect of this process was to develop certain basic principles which must be reflected in any rule which independent producers, along with other industry members, will support. These principles are as follows:

1. First, the royalty valuation point must remain at or near the lease consistent with statutory provisions.

2. Second, an alternative gas valuation methodology must be preserved. At the same time, the methodology must be simple enough to be utilized by all lessees who qualify.

3. Third, some royalty-related issues, such as gross proceeds, affiliated sales, gas contract settlements, and deductible transportation costs after FERC Order 636, are the subjects of legal disputes. A negotiation should not require that either party fully concede on a disputed legal issue. The Trade Associations will not agree in a negotiated rule to concede on legal positions they have articulated in good faith, nor do they expect MMS or the states to do so.

4. Fourth, an exception to entitlements must be meaningful.. This issue has been addressed by the Royalty Simplification and Fairness Act of 1996 and regulations should be consistent with that legislation.

5. Fifth, a true-up of index payments is acceptable as a means of addressing concerns about revenue neutrality and market value. However, the safety net calculation should not require an audit of gross proceeds payments beyond the existing standard procedures of the MMS. Further, the true-up should not be based on an index payor's own gross proceeds or its affiliate's downstream proceeds.

With respect to the first two principles, other MMS initiatives must be considered in terms of their potential impact on this rulemaking. It is of great concern to the Trade Associations and their members that rules to implement FERC Order 636 have just recently been published. Any rules implementing Order 636 must, of necessity, be closely integrated with gas valuation regulations. The Trade Associations are concerned that the proposed rule to implement FERC Order 636 takes royalty valuation further away from the lease in contravention to statutory authority. As the Trade Associations further analyze and prepare comments on the Order 636 rulemaking, we may find inconsistencies between the two rulemakings and will make comments to that effect. The Trade Associations strongly urge the MMS to review the comments received in this rulemaking and the Order 636 rulemaking jointly; neither rulemaking should be made in isolation from the other.

It is critical that alternatives be developed that restore certainty and create simplicity for paying royalties on natural gas production, not further compound the problem. It is for this reason that a number of our members support additional "Royalty-in-Kind" pilot projects. Consistent with the Senate appropriations bill for the Department of the Interior, at least one pilot project should be conducted onshore. The independent producers believe that properly designed Royalty-in-Kind pilot projects can assist in developing dramatically simplified valuation procedures as well as support the principle of valuing gas at the point it leaves the lease rather than further and further downstream.

With these principles in mind, the Trade Associations examined each of the five options published by the MMS. Although some of the options were developed ostensibly to respond to concerns expressed by the independents, none of the options adequately addresses these concerns, particularly the need for simplification and reduced administrative burden. In fact, many of the options increased the administrative burden substantially. Further, certain options, particularly those presented by the state representatives at the June 12-14, 1996 Committee meeting, ignored the concessions that had been made by industry and attempted to "cherry pick" from the industry concessions without making any concessions of their own. Clearly, that is an unacceptable approach to negotiated rulemaking.

After examining the MMS options IPAMS and IPAA, in conjunction with API, COPAS, RMOGA, and NGSA, developed a unified industry proposal which met the principles stated above and which was presented when the Committee reconvened June 12-14, 1996. (The unified industry proposal is attached hereto and incorporated herein by reference.)

The key components of that proposal are:

- A meaningful exception for takes based reporting in mixed agreements, along with an expanded period in which to reconcile to entitlements (This issue is addressed in the Royalty Simplification and Fairness Act of 1996 and regulations should be consistent with that legislation.)
- Index would be applied to the wellhead MMBtu less a location differential to the appropriate Index Pricing Point.
- The MMS would calculate the safety net price using unaudited gross proceeds as reported on MMS-2014's. The index payors would true up to 75% of the difference between the index payor's weighted average index based value and the median price for unaudited gross proceeds on a zone-by-zone basis.
- If the safety net is not published within one year following the end of the index year, then no additional royalty would be due and the index would become the final safety net.
- Gross proceeds payors would have the option for all Federal leases to apply a gross-proceeds based gas value to the wellhead MMBtu less applicable transportation with no safety net.

During the June meeting of the Committee the states and some MMS members expressed strong opposition to the use of unaudited gross proceeds for calculation of the safety net. The industry representatives agreed, as an additional concession, either to true up to 90% of the difference between the index payor's weighted average index based value and the median price for unaudited gross proceeds on a zone-by-zone basis or to increase the safety net median value to account for the average net increase in revenues from audits. Industry proposed a 1% increase to the safety net based on a study showing that 1% was the average net increase in revenues attributable to audits.

The states' opposition to unaudited gross proceeds, including gross proceeds adjusted for audits, seems to be based more on a perception that gross proceeds, in general, are not an adequate safety net, rather than any likelihood that unaudited gross proceeds will vary significantly from audited gross proceeds. When industry offered to increase the safety net median value to account for the uplift from audits, the response from the states was that the safety net median value, whether based on audited or unaudited gross proceeds, would always be lower than the comparable proceeds from index payors.

The states, then, proposed several alternatives, none of which were acceptable for a number of reasons. The comments filed by RMOGA and NGSA detail the basis for industry's objections to the various state proposals and the Trade Associations adopt and incorporate those objections into these comments. The Trade Associations particularly object to proposals to eliminate transportation allowances, since, as stated above, such proposals attempt to establish value for royalty purposes based upon prices at sales points remote from the lease.

The Trade Associations also support the statement made by RMOGA that MMS accorded excessive significance to the comments of the states but virtually ignored the comments of the small independent producers. In that context, the Trade Associations express their concern for the appropriateness of MMS caucusing with the states during the June meeting and supporting only what the states supported. We are especially concerned because these caucuses occurred during the reopened public comment period for rulemaking. When the independents worked diligently with other associations to develop an alternative that fairly met the needs of all for fairness and simplicity, that alternative was dismissed out of hand in an unfair manner.

The Trade Associations and their members still strongly support the unified industry proposal, including the additional alternatives presented by industry at the June 1996 meeting of the Committee. We believe that the proposal has benefits for all concerned, particularly in terms of alleviating the administrative burden associated with the safety net calculation.

In conclusion, the Trade Associations cannot support the options proposed by the MMS or the states. The option which the Trade Associations support is one that meets the principles stated above and most importantly, one that simplifies the methodology for paying royalties on natural gas production without shifting the audit burden to the gross proceeds payors while preserving a meaningful exception for takes based reporting.

The Trade Associations thank you for the opportunity to comment on these options.

Very truly yours,

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